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Economic Regulation Authority
PO Box 8469
PERTH BC WA 6849

via email to: submissions@erawa.com.au

Dear Ms Cusworth

RESPONSE TO ISSUES PAPER ON PROPOSED REVISIONS TO THE MID-WEST AND SOUTH-WEST GAS DISTRIBUTION SYSTEMS ACCESS ARRANGEMENT

Synergy welcomes the opportunity to make a submission in response to the Economic Regulation Authority's (**ERA**) issues paper on ATCO Gas Australia's (**ATCO**) fifth access arrangement (**AA5**) proposal.

[redacted]

<u>Overarching comments</u>

Synergy notes the ERA in performing its functions is required, under section 26(1) of the *ERA Act 2003,* to have regard to:

"(a) the need to promote regulatory outcomes that are in the public interest;

(b) *long-term interests of consumers in relation to the price, quality and reliability of goods and services provided in the relevant markets;*

…

(d) *legitimate business interests of investors and service providers in relevant markets;*

…

(g) the need to promote transparent decision-making processes that involve public consultation."

The ERA also has an obligation under section 28(1) of the National Gas Law (**NGL**) to perform or exercise its functions and powers in a manner that will or is likely to contribute to the achievement of the national gas objective (**NGO**). The NGO is:

> *"to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas."*

In addition, under section 28(2) of the NGL, the ERA:

(a) *must take into account the revenue and pricing principles—*

i. *when exercising a discretion in approving or making those parts of an access arrangement relating to a reference tariff; or*

ii. *when making an access determination relating to a rate or charge for a pipeline service; and*

(b) *may take into account the revenue and pricing principles when performing or exercising any other [ERA] economic regulatory function or power, if the [ERA] considers it appropriate to do so.*

The purpose of this submission is to provide advice to the ERA to help inform its decision on ATCO's AA5 proposal. In this submission Synergy has identified aspects of ATCO's proposal that warrant particular scrutiny, clearer justification and require additional supporting information to enable network users (and end customers) to determine whether ATCO's proposal is efficient.

The following sections of this submission address Synergy's key concerns with ATCO's AA5 proposal.

<u>Price path</u>

ATCO is proposing a price path that incorporates a step change between 2019 and 2020 (in the order of 24%) and then smooth significantly smaller annual price increases per year (1% to 2.3% depending on the customer tariff class).

Synergy acknowledges the declining AA4 price path and the resulting transitional issues into the following access arrangement period is a large contributor to the proposed price increase required for AA5. However, Synergy understands that 10% of the proposed 24.4% step change increase for industrial and commercial customers (A1, A2, B1, B2) is a direct result of ATCO's proposed revenue requirement for 2020.

Synergy submits price increases of this magnitude are untenable for customers and constitute price shock. Further, the large industrial and commercial customers that are most heavily impacted by the price increases (the average A1 tariff attracts a 25.8% increase between 2019 and 2020) have limited ability to mitigate this price shock. Unlike residential customers, many industrial users cannot move away from gas as a fuel due to the high capital costs invested in operations.

This means the impact of significant increases in industrial/commercial gas customers' energy costs (as would be borne out by ATCO's proposal if accepted in its current form) would likely need to be passed through by retailers to their end customers to remain commercial. However, such an approach is likely to negatively impact competition and the legitimate business interests of gas retailers[1].

ATCO states it has sought to minimise tariff variability within and between access arrangement periods, but has proposed a 20+% increase between AA4 and AA5. Such large price changes cannot be considered to meet the pricing principles in section 24(5) of the NGL which requires:

> *"A reference tariff should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff relates*."

Synergy submits the commercial risk to ATCO will not increase by 24% between 2019 and 2020 and highlights there are alternative price paths that would better achieve the pricing principles more broadly. Synergy would support a similar approach to the tariff re-balance required by ERA in relation to Western Power's (AA4) transmission and distribution network.

In its submission, ATCO suggests it has considered the issue of price shock and suggests that the findings from its stakeholder engagement program support the proposed price path. However, Synergy considers ATCO's findings from its stakeholder engagement process were:

- not adequately weighted to reflect the interest in, and impact on various stakeholders;
- targeted towards end-use customers rather than the network users i.e. retailers;
- heard, but not actioned; and
- in some instances, potentially mispresented.

Synergy therefore considers little weight be placed on ATCO's 'Voice of Customer' outcomes.

In particular, Synergy considers the engagement strategy did not adequately take into account the long term and legitimate business interests of vulnerable consumers[2] and was not focused on balancing the interests of ATCO, retailers (as network users) and consumers who primarily rely on gas as a fuel source. Synergy considers the views of a very small number of end use customers have been given disproportionally more weight than the views of ATCO's customers (i.e. network users) in support of ATCO's proposed price path.

[1] It would potentially make gas less competitive in the short-term, for example in relation to new customers not connecting and existing customers who can cost effectively move away from gas to an alternative energy supply.

[2] Customers whose business solvency and survivability would be negatively impacted by the step price increase.

Synergy considers the likely achievement of the national gas objective and the long term legitimate business interests of gas consumers should have been a fundamental and the primary goal of ATCO's stakeholder engagement strategy. Such an approach would have been consistent with the NGL.

In its Voice of Customer findings in relation to the extreme price increase, ATCO states[3]:

> *"[r]etailer concerns regarding the proposed amount of the initial price increase in 2020 have been heard. Consequently, we have moderated the initial price increase by an annual real price increase of 2.3%."*

Synergy submits proposing smaller price increases in the latter years of the AA5 period does not moderate the initial step change. Synergy's concern relates to the size of the initial price increase and the impact such price shock has on commercial arrangements and consumers who rely on gas as a fuel source.

Further, ATCO has not demonstrated how its proposed price path will meet the pricing principles under the NGL or the NGO. While ATCO may have heard the concerns from retailers regarding the magnitude of the initial price increase, it does not appear to have acted on these concerns.

ATCO notes[4]:

> *"[m]ost customers (76% overall, with 86% for residential, 74% for SME and 25% for C&I customers) chose a stable price path as their preference for paying for the increase in costs…We found that customers tolerated the larger cost increase in the initial year as they viewed the step change as relatively modest.".*

This statement is misinformed in respect to the acceptance of the price increase. While 86% of residential customers may have indicated a preference for a step change, it should be noted that these customers will not actually see that step change fully reflected in their bills. This is because the retail gas tariffs retailers are permitted to charge small use customers are capped by Government policy settings.

The step change price increase will most significantly impact commercial and industrial customers, who will feel the full impact of network price increases. Only 25% of commercial and industrial customers were in favour of the large initial price increase. However, it should be noted the engagement findings did not reflect the impact on the business interests[5] of these customers and therefore does not demonstrate how the approach is "…*for the long term interests of consumers of natural gas with respect to price…"* and quality of supply.

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[3] Access Arrangement Information for ATCO's Mid-West and South-West Gas Distribution System, 31 August 2018 (Page 163).
[4] Access Arrangement Information for ATCO's Mid-West and South-West Gas Distribution System, 31 August 2018 (Page 16).
[5] Including business solvency and survivability.

ATCO notes it engaged with retailers and customers early to advise of the proposed price increase and that doing this avoids price shock. Synergy suggests that merely being forewarned of a 24% price increase does not mitigate the financial consequences of price shock. The price increase will still have a detrimental impact on commercial businesses if and when it comes into effect. Having prior knowledge of the increase does little to soften the blow.

While ATCO's attempts to engage with stakeholders when developing its AA5 submission should be recognised, it does not absolve ATCO from its responsibilities to ensure the price increases it proposed are not to the severe detriment of customers and to demonstrate that its proposal is consistent with the NGO.

Forecast capital expenditure

The increase in revenue (and therefore prices) is largely driven by ATCO's significant forecast capital expenditure program. ATCO highlights the proposed capex program is only 2% above the AA4 period. However, it should be noted the AA4 period was 5.5 years long. When compared with a five-year period, the increase in the proposed capex appears to be closer to 10%.

Synergy highlights the AA5 proposal includes very little information on the outcomes of the proposed capex program for customers. In particular, there does not appear to be adequate substantiation in relation to how it meets the requirements of NGR 74 or 79. Synergy considers this substantiation is also necessary to demonstrate consistency with the NGO.

NGR 74 requires that:

- the basis of the forecast must be stated;
- forecasts must be arrived at on a reasonable basis; and
- forecasts must represent the best estimate possible in the circumstances.

In addition, NGR 79 requires (amongst other things) new capex to only be incurred by a service provider acting prudently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services.

The AA5 proposal also provides limited information about the capex program and does not demonstrate in sufficient detail how it meets NGR 74 or 79. This makes it difficult to assess the reasonableness, prudence or efficiency of the proposed capex program.

Synergy notes, in its issues paper the ERA has only highlighted sustaining capex for consideration by stakeholders. However, Synergy considers all aspects of the capex program should be reviewed by the ERA in detail and substantiated in relation to NGR 74 and 79.

Synergy recommends the ERA scrutinises the following key areas in its review of forecast capex:

- The 5% (adjusted) increase in growth capex, despite the modest growth in customer numbers and declining demand expected over the AA5 period.

- The 24% (adjusted) increase in sustaining capex, despite exceptional reliability and security of supply performance, materially outperforming the benchmarks set for AA4.

- The significant amount of discretionary capex. For example, IT capex is forecast to increase by almost 50% from $25 million (adjusted to 5 years) to $36 million which appears to be largely driven by a desire to upgrade third-party software systems.

Forecast operating expenditure

Another key contribution to ATCO's revenue requirement is its high and increasing operating expenditure forecast. The NGR contemplates that ATCO would seek to achieve the lowest sustainable costs in relation to providing the relevant services, to ensure the efficient operation and use of, natural gas services for the long term interests of consumers. Therefore, Synergy would expect the ERA applies a similarly methodical and robust process to review the legitimacy of each element of the forecast method to ensure that the forecasts meet NGR 74 and 91.

NGR 91 states:

> *"Operating expenditure must be such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of delivering pipeline services"*

It appears ATCO has adopted an approach of straight cost escalation and pass-through. Synergy considers that this approach does not meet the requirements of NGR 91 as a cost pass through approach that does not account for economies of scale or efficiencies as a result of its capex programs and therefore cannot reflect the lowest sustainable cost.

ATCO is applying the base-step-trend method to develop its opex forecast. Synergy considers this is a reasonable and generally accepted method for determining a regulated business' efficient level of operating costs.

However, rather than using its most recent revealed costs as the basis for the estimate as is customary in the base-step-trend method, ATCO proposes to use the estimated 2019 operating costs as the base year. On this basis, ATCO is purporting that the forecast made five years ago is the most accurate indication of its efficient base opex costs. ATCO then proposes to remove the efficiencies achieved two years prior as the most accurate indication of the efficiencies likely to be achieved as a result of a number of high-value capex and opex efficiency driven programs such as its major upgrade of SAP during AA4.

This proposal appears counter-intuitive and unlikely to yield an accurate assessment of ATCO's efficient opex levels. More importantly, using an estimated and a speculative assessment of future costs does not appear to be consistent with the requirements of NGR 74 in that:

> *(2) A forecast or estimate:*
>
> > *(a) must be arrived at on a reasonable basis; and*
> >
> > *(b) must represent the best forecast or estimate possible in the circumstances.*

Synergy submits the latest year of actual expenditure should be used as the base year opex and indirect cost forecasting models, and then 2018 and 2019 efficiencies, as well as forecast AA5 efficiencies must be identified and removed from ATCO's forecasts.

Synergy expects that ATCO has identified specific areas where step changes that decrease opex costs can be sustainably achieved. Each project that ATCO has stated will, or could reasonably be expected to deliver productivity or efficiency improvements should be removed from forecast opex to achieve the lowest sustainable cost to provide the relevant service. For example, the AA5 upgrades to IT systems, including SAP, and significant investment in SCADA and remote control capability would only be included in ATCO's forecast if they were expected to deliver efficiencies. These specific reductions should be removed so customers benefit from the capex/opex trade-off.

ATCO suggests due to the favourable benchmarking performance, there should be no additional productivity growth or efficiency targets applied to AA5 opex. Customers expect ongoing efficiencies and standards to be maintained or improved. Not only has ATCO not included any additional efficiencies, it has not included any further efficiencies between 2017 and 2019 by way of its forecasting method. Synergy does not consider this is realistic or reasonable and highlights that it is inconsistent with seeking the requirements of NGR 91.

It should also be highlighted that ATCO suggests its benchmarking exercise indicates its opex per km of mains and opex per customer connection is amongst the best in Australia as at 2017. However, its key performance indicators relating to opex both increase significantly (by around 12%) between 2017 (the most recent actuals) and the estimated 2019 values. This would reduce its performance to closer towards the middle of the group of gas distribution network service providers. Moreover, as the AER has recognised, benchmarking is a fraught activity when it comes to setting expenditure allowances.

Synergy also observes corporate opex, which accounts for around 25% of total opex (based on the bottom-up forecast produced by ATCO), appears high in comparison with other regulated network businesses. This is magnified by the fact that the $91.4 million appears to be made up of direct costs and there are also indirect costs included in the capex forecast.

ATCO's submission provides little information about what these opex and indirect costs are. Synergy therefore questions the size of the corporate overheads (from ATCO Australia and ATCO more broadly) allocated to the Australian regulated gas business (whether called corporate costs or indirect costs) and seeks the ERA to require ATCO to substantiate these costs in greater detail.

Synergy considers the rates for consistent parameters such as the calculation and application of opex inputs such as network growth parameters and labour growth escalation should be consistent with the ERA's September 2018 final decision on Western Power's access arrangement.

Key performance indicators

Synergy recognises because ATCO is under a price cap form of regulation, its KPIs are not linked to any financial reward or penalty scheme. However, these measures provide a meaningful benchmark for retailers, customers and the ERA to assess ATCO's performance over time.

Synergy notes that the KPIs for ATCO's AA4 appear to have been set at levels that will be easily met, arguably to the extent that the benchmarks appear meaningless and could allow service to decline significantly. Synergy therefore recommends the ERA reviews ATCO's proposed AA5 KPIs to ensure the benchmarks set are meaningful to users and provide a realistic target and potentially a stretch target. This is particularly important as ATCO forecasts worsening performance in each of its measures in 2018 and 2019.

Network innovation and rebate schemes

Network innovation is important to achieving the lowest sustainable costs in relation to providing services. Therefore, Synergy supports ATCO's continued network innovation and highlights that both historical and forecast expenditure includes marketing and business development costs for such activities. A business under a price cap should have sufficient commercial incentives to use this allocated expenditure along with its own funds to innovate to increase its revenue or sustainably reduce the cost of services.

In relation to ATCO's proposed developer rebate scheme, it should be noted that despite ATCO's forecasts of declining demand it has forecast continual and steady growth in customer numbers. Synergy considers ATCO should use its existing general marketing and business development expenditure allocation to support developers if ATCO considers it valuable and consistent with the NGO. Synergy therefore does not support the program being funded from tariffs or being enshrined as a fixed principle in the access arrangement.

Synergy considers it important to delineate new business development (or entrepreneurial schemes) from innovation in relation to providing reference services. Therefore, Synergy does not support the introduction of a network innovation scheme funded by network users.

Specifically, Synergy does not consider that ATCO's customers should fund cutting-edge or entrepreneurial research and development projects such as those involving hydrogen, which are only loosely linked to the provision of gas distribution reference services. Further, Synergy recommends the ERA reviews ATCO's historical and forecast expenditure in relation to innovation to ensure tariffs have only been spent on those projects that deliver value to customers in the provision of reference services, consistent with the NGO.

Going forward, Synergy recommends the ERA requires ATCO (and other monopoly network businesses) to implement robust ring-fencing (at least financial ring-fencing) to ensure reference tariffs are not being spent on competitive services, which should be unregulated and treated as services that are subject to effective competition.

Other matters

Synergy considers the ERA's September 2018 final decision for the Western Power Network should be used as a baseline for the ERA's decision on ATCO's AA5 proposal, with any variations from those positions and outcomes clearly justified by the ERA in the draft decision.

Synergy confirms that this submission can be made publicly available other than the matter expressly identified as commercial in confidence. Should you require further information regarding any of the comments made in this submission, please contact me.

Yours sincerely

[redacted]

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MANAGER REGULATION AND COMPLIANCE